No. 11160

In the United States Circuit Court of Appeals for the Ninth Circuit

Babette G. Lurie, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

SEWALL KEY,
Acting Assistant Attorney General.
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FILED

PAUL P. O'BRIEN,
CLERK

INDEX

CITATIONS

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 13–21) are reported at 4 T. C. 1065.

JURISDICTION

This petition for review involves income tax for 1941 in the amount of $1,177.03. (R. 22–25.) On October 22, 1943, the Commissioner of Internal Revenue mailed a notice of deficiency to the taxpayer. (R. 7–11.) Within 90 days thereafter, i. e., on December 6, 1943, the taxpayer filed its petition with the Tax Court for a redetermination of the deficiency under Section 272 of the Internal Revenue Code. (R. 1, 3–6.) The tax Court entered its decision on March 31, 1945, finding the deficiency in the amount stated

above. (R. 22.) The petition for review by this Court was filed June 16, 1945 (R. 22–25), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether, in computing her net income, the taxpayer should include, as ordinary income, the entire amount of gain realized by her upon retirement of certain preferred income notes which she had held for about two years but which were returned to the issuing company for registration less than 18 months before retirement; or whether such gain constituted long-term capital gain under Section 117 of the Internal Revenue Code, and is taxable only to the extent provided therein.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from * * * professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever, * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1);

(2) *Short-term capital gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

*   *   *   *   *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

*   *   *   *   *

(b) *Percentage taken into account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a

capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

*   *   *   *   *

(f) *Retirement of bonds, etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

*   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 117.)

STATEMENT

The facts as found by the Tax Court are as follows:

The taxpayer and her husband reside in San Francisco, California. They filed their income tax returns for the year 1941 with the Collector of Internal Revenue for the First District of California. (R. 14.)

In 1938 the Hilton Hotel Company of California (then known as Huckins-Newcomb Hotel Company), hereinafter called the company, had outstanding various stock, bonds, notes and other obligations. A group of individuals, including the taxpayer, acquired all of such securities and obligations. In order to

facilitate the handling of them, units were formed, consisting of an equal percentage of all of the securities and obligations. Thereupon, pursuant to permits of the Commissioner of Corporations of California, each member of the group received voting trust certificates, promissory notes and other securities in proportion to the number of units held by him. Included was a series of preferred income notes in the total amount of $203,747.94, issued pursuant to a permit of the Commissioner of Corporations. Each note was a printed document containing no reference to registration. (R. 14.)

At the time of the original issuance of the notes, the taxpayer and her husband jointly owned approximately one-third of the units and therefore owned one-third of the outstanding securities, including one-third of the total amount of the preferred income notes. Shortly thereafter, late in the year 1938 and early in 1939, they acquired additional units and included in each were preferred income notes which were acquired at less than face value and which are involved herein. After the acquisition of these additional units, they owned slightly in excess of 40 percent of the units. (R. 15.)

The voting trustees in the voting trust certificates included in the units consisted of the taxpayer's husband, Louis R. Lurie, C. N. Hilton and Don B. Burger, the last named being an owner of a small number of voting trust certificates and prior preferred income notes and an employee of C. N. Hilton. The remaining voting trust certificates and prior preferred income notes (and other securities of the corporation

in the same proportion) were owned by C. N. Hilton and various associates of his who at all times controlled the company and whose attorney was employed as attorney for the company. The directors of the company consisted of Louis R. Lurie, his auditor J. A. Kurzman, C. N. Hilton, Don B. Burger and Packey Dee of Chicago. (R. 15.)

In the application for the permit to issue the promissory notes, it is recited: "Said new promissory notes are to be registered and applicant hereby designates itself to act as the registrar thereof". Annexed to the application was a printed form of a preferred income note and there was an additional printed page entitled "Registration", on which was set forth a form for registering the notes. When the notes were finally printed and issued, the page entitled "Registration" was omitted. In August of 1940, the company requested the holders of the notes to return them to it. (R. 15–16.)

The notes were thereupon returned to the company and on the face of each of the notes was printed the following (R. 16, 28): "Notice to Holder: This note may be registered as provided on the back hereof", and on the back of each was printed the following (R. 16):

> This note may be registered in the holder's name upon a register to be maintained by the Company at its office in San Francisco, California. Such registration shall be noted on this note by the Company, after which no transfer hereof shall be valid unless made on said register and noted on this note. The Company may deem and treat the person in whose

name this note is from time to time registered as the absolute owner hereof for the purpose of receiving payments of principal and interest due hereon and for all other purposes.

(Registration)

Notice to Holder: Do not write on this note. Consult the Company for method of transferring registration.

Date of Registry: In Whose Name Registered: Register Hilton Hotel Company of California.

By______________________________
Authorized Officer.

On August 6, 1940, the taxpayer and her husband returned the notes involved herein and had them registered in the husband's name. A photostatic copy of one of the original notes, after registration, is in the record and reference is here made to it. For the year 1940 they returned the profit on the principal payments made on account of the notes in that year after registration as a capital gain and the Bureau of Internal Revenue held it to be ordinary income. The taxpayer acceded to the contention of the Bureau on advice of counsel that, regardless of whether or not the notes were in registered form, the notes were not retired in the year 1940 as required by Section 117 (f) of the Revenue Act in order to fall within its terms. (R. 17.)

All of the notes in question were retired in 1941, more than two years after the acquisition of them by the taxpayer and her husband and less than 18 months after the date that the notes were returned to the company and registered as stated above, at a profit

to each of them in the amount of $3,448.53. This profit was returned by each as a capital gain. The Commissioner determined that such profit was ordinary income. (R. 17.)

The Tax Court held that the taxpayer was not entitled to treat her profit as a capital gain. Accordingly it found a deficiency in income tax for 1941 in the amount of $1,177.03. (R. 21–22.)

SUMMARY OF ARGUMENT

The Tax Court correctly held that the gain realized from the retirement of the notes involved here is subject to tax in its entirety. As the privilege which taxpayer seeks relates to an exemption from tax on a portion of the gain admittedly received, the statute must of course be strictly construed against her, and the privilege can be granted only upon clear statutory authority. The statutory provisions on which the taxpayer relies to show that 50 percent of such gain may be excluded from gross income require that the notes be issued by the corporation in registered form but it is admitted that the notes here were not so issued and were not put into registered form until a year before their retirement. In contending that such registration was sufficient, taxpayer argues that it is not necessary that they be in registered form throughout the required holding period, but this view is erroneous because it ignores the plain meaning of certain language in the statute. It also permits various provisions of the statute to be construed and applied separately and without regard to other provisions. However, whenever the section covering capital gains and losses is read as a whole, it will be

seen that Congress has granted the privilege of excluding a portion of the gain realized from the retirement of notes only when such notes have been held throughout the required period in registered form.

ARGUMENT

The Tax Court correctly held that the gain realized upon the retirement of the notes involved here was not a long-term capital gain within the meaning of Section 117 of the Internal Revenue Code and so was taxable in its entirety

In taking this appeal from the Tax Court's decision, the taxpayer is seeking to have this Court hold that 50 percent of the gain, which she admittedly realized upon the retirement of the corporate notes involved here, should be excluded from taxable income. Obviously, in order to maintain her position, the taxpayer must do more than show that the applicable revenue statute does not specifically prohibit the exclusion of such portion of this income. She must point to a provision in the statute specifically authorizing the exclusion but we submit that she has not and cannot do this.

The taxpayer relies on Section 117 of the Internal Revenue Code, *supra,* which refers to capital assets. Her argument, in substance, is that, since the notes here are capital assets within the meaning of that section and were acquired more than 24 months before their retirement, the income realized therefrom was "long-term capital gain" as defined in paragraph (a) (4), and so only the percentage designated in paragraph (b) of that section need be taken into account when computing her net income.

The taxpayer of course recognizes that she must meet the requirements of Section 117 (f), *supra*, which refers specifically to the retirement of bonds and notes, but contends that she has met these requirements and appears to deny that subsection (f) must be read or considered with the other provisions of Section 117. At least counsel for taxpayer asserts (Br. 10) that the provisions covering the holding periods for capital assets have no relation whatsoever to Section 117 (f) and states (Br. 8) that the sole issue here is whether or not the retirement of the notes constituted a sale or an exchange. We cannot agree.

It is of course well established that the retirement of bonds or notes is actually not a sale or an exchange when those terms are given their usual and ordinary meaning. *Fairbanks* v. *United States*, 306 U. S. 436. Furthermore, prior to the passage of the Revenue Act of 1934, gain realized upon the retirement of bonds or notes was treated as ordinary income, but by the insertion of subsection (f) in Section 117 of that Act. Congress brought the retirement of certain securities for the first time within the category of capital gains and losses. *McClain* v. *Commissioner*, 311 U. S. 527. Specifically, Section 117 (f) provides that the amounts received by the holder upon the retirement of such securities "shall be considered as amounts received in exchange therefor." But the significant and, for our purpose, decisive portion of Section 117 (f) is that describing the securities which may be so treated. These include—

> bonds, debentures, notes, or certificates or other evidences of indebtedness *issued by any cor-*

> *poration* * * * with interest coupons or *in registered form*, * * *. [Italics supplied.]

Language in a statute is to be given, of course, its ordinary and usual meaning. Thus the word "issued", when given its generally accepted connotation, means sent forth or given out, but when that definition is applied here it must be admitted that these notes were not *issued* in registered form.[1] The notes were actually issued by the corporation in 1938 and in 1939 but registration did not occur until after August of 1940. (R. 15, 16.) In that month the corporation requested that all notes be returned for registration and certain statements relative to registration were printed on them. Then, for the first time, could it be said that they were in registered form as required by Section 117 (f). Consequently, it is our first contention that the taxpayer fails here because she cannot show that the notes were in registered form at the time of their issuance.

The Tax Court found it unnecessary to pass on this contention (R. 21) and counsel for the taxpayer, while admitting that the notes had to be in registered form before retirement, argue that our view of the statute places an unwarranted limitation upon normal business transactions (Br. 12). In other words, while counsel admit that the taxpayer realized gain from the retirement of her notes and that such gain would be entirely subject to tax without the provisions in subsection (f), they now argue, in effect, that she

[1] As it is not claimed that there were any interest coupons attached, the taxpayer is required to show that the notes here were in registered form.

should be accorded the privilege of excluding 50 per cent of such gain from tax without showing that she comes strictly within its provisions.

It is of course well established that all provisions granting exemptions from tax will be strictly construed and in favor of the Government to the end that the revenues will be protected. Moreover, the statute must be construed and applied as written. Congress used the term "issued" and surely did not mean for it to be treated as a superfluous word as counsel for the taxpayer implies. We submit that, as the notes here were not *issued* in registered form the taxpayer does not come within the language of Section 117 (f).

However, if we are wrong in our first contention, and if it is sufficient that the notes be registered before retirement, we submit it is still evident that the taxpayer should not prevail here for, as the Tax Court held (R. 21), the notes must be placed in registered form more than 18 months before retirement in order for the gain which is realized therefrom to be treated as long-term capital gain within the meaning of Section 117 (a) (4).

In disagreeing with the Tax Court's interpretation of Section 117, counsel for the taxpayer contend that subsection (f) has no relation to, and need not be considered with, the provision prescribing the holding period for capital assets. Thus, under the taxpayer's view, a note which had been held for two years could be returned, as here, and put into registered form, even if such action was taken only one day before retirement; and still the gain therefrom should be treated as a long-term capital gain, taxable only to

the extent indicated in subsection (b). But as the Tax Court so aptly pointed out (R. 20)—

> Such a last-minute registration just before retirement, even after the call for retirement has been issued, would permit the holders of notes or other securities to determine for themselves, in accord with their individual advantage, the tax consequences that would flow from retirement without regard for uniformity of treatment or the interests of the Government. The suggested interpretation seems contrary to the whose basic concept of section 117 (f).

The Tax Court is undoubtedly right. If notes need not be held in registered form for more than 18 months in order to treat the gain from retirement as long-term capital gain, then taxpayers can choose their time for registration. Thus they could postpone registration until it was known whether the contemplated retirement would result in a gain or a loss, and if the latter was expected they could decide not to register the notes at all. In such case they would not come under Section 117 at all and could deduct the whole loss. On the other hand, if they saw a gain would be realized, they could register their notes shortly before retirement and enjoy the privileges of Section 117. Certainly the situation can be so controlled if the taxpayers are stockholders of a closely owned corporation, as is the husband of taxpayer here. But we submit that it was not the intention of Congress to leave the matter open in this way and that it has not done so.

In contending otherwise, counsel for taxpayer consider it sufficient to show that the notes here were

capital assets, that they were held for two years or more, and that they were retired by the issuing corporation. We do not of course deny such facts but we maintain that, since the taxpayer would be taxable on the entire amount of realized gain without subsection (f), she can secure the privilege she now seeks only by showing that throughout the required holding period, her notes were actually the kind of notes referred to in subsection (f), namely, notes in registered form. If for one year of that time, the notes were not the kind to which this special privilege attaches, then how can the taxpayer claim that she was within the requirements of Section 117? We think it is evident that she should not be allowed to do so and if the limitation seems a hard one, that is a matter for Congress to remedy.

Counsel for taxpayer refer (Br. 11) to notes which are sold but its illustration is not helpful here. Any note is a capital asset and if sold at a profit after two years, the gain therefrom is clearly taxable to the limited extent permitted by Section 117 but obviously, since that transaction does not involve a retirement, subsection (f) has no application and registration need not be considered at all in the example cited.

Counsel also refer to other cases to illustrate their contention that it is the status of an asset at the date of sale or exchange which is controlling. (Br. 12–14.) The answer to such contention is also that we do not have either a sale or exchange here, but a retirement which is accorded a special treatment. Furthermore, by the special permission of Congress, granted in Section 117 (f), gain from retirement may be only treated

as an amount received on an exchange if the security involved is one of those described therein, and the significant date is the issuance of the security for it is then that its nature can be determined. Or if, as here, a note is issued without registration but is recalled and changed into registered form, then reissued, its determining character may date from the reissuance, as the Tax Court held.

Consequently, the situation in the instant case is different from that in cases like *Kimbell* v. *Commissioner*, 41 B. T. A. 940, relied on by the taxpayer. That case involved a house which was first used as a residence and later for business. In determining how much of the gain or loss was includible in net income under Section 117 (b), it was held there that the whole period for which it was held could be considered. Of course a house is a capital asset regardless of what kind of property it is and there are no limiting provisions in Section 117 which might prevent the gain or loss from the sale thereof from being treated as a long-term capital gain or loss. Thus all that had to be determined there was the period for which it was held. But in the case of notes there are qualifying provisions in subsection (f) and if such notes meet those requirements for only a portion of the required holding period in subsection (b), with which it must necessarily be read, then it cannot be said that the taxpayer was holding the kind of note required by subsection (f) for the full period.

Indeed, when the notes are unregistered for a portion of the period, as was true here, the situation is

similar to that in which two closely related kinds of property are held. In the latter case, a taxpayer is not permitted to add the periods for which he has held the two kinds of property in order to show that he has met the statutory requirement for holding. Thus, in the case of *In re Rogers' Estate,* 143 F. 2d 695 (C. C. A. 2d), certiorari denied, 323 U. S. 780, the period for which shares of stock were held could not be added to the period of holding the notes given in payment therefor in determining how much of the gain was includible in net income under Section 117. Also cf. *Helvering* v. *San Joaquin Co.,* 297 U. S. 496, in which a taxpayer was not allowed to add the period for which he held an option to buy certain land to the period of holding the land; *Howell* v. *Commissioner,* 140 F. 2d 765 (C. C. A. 5th), holding that the period in which a lease was held in escrow could not be added to the period extending from delivery of the lease to its sale; *Sommers* v. *Commissioner,* 63 F. 2d 551 (C. C. A. 10th), in which it was held that the period for holding stock dates from its issue rather than the date it was subscribed for; and *Commissioner* v. *C. A. Sporl & Co.,* 118 F. 2d 283 (C. C. A. 5th), in which the holding period was held to begin with the date when the taxpayer relinquished its rights as a general creditor and agreed to accept bonds for the unpaid portion of the debt.

We submit that these cases, while obviously referring to different situations, indicate that counsel for taxpayer is in error in implying that a taxpayer may add various periods together to meet the statu-

tory requirements here involved. Instead, when there is a change in the nature of the property, the period for which the particular kind of property has been held may not be added to the holding period for another kind of property, although closely related to the first.

In the instant case, the taxpayer acquired notes which were not registered and then returned them in 1940 to have them put in registered form. This change was not inconsequential and should not be passed over lightly. The purpose of registration is well known and important. It is a protection to the owner against theft and provides him with a proper and safe way of transferring his holdings. *Gerard* v. *Helvering,* 120 F. 2d 235 (C. C. A. 2d); 3 Thompson on Corporations (3d Ed.), Sec. 2344. Congress was of course aware of the difference between registered and unregistered evidences of indebtedness and clearly intended to extend the provisions of Section 117 (f) only to persons who had held notes in registered form for the period required by subsection (b).

Gracey v. *Commissioner,* 5 T. C. 296, now pending on the Government's appeal to the Circuit Court of Appeals for the Fifth Circuit, involves subsection (h) (1) of Section 117, which, since it refers only to property acquired in connection with a nontaxable exchange, has no application here. Thus that decision, though now being contested by the Government, can have no bearing on this case.

Accordingly, we submit that, when full effect is given to the language of Section 117 (f), and it is read

and considered with the remainder of Section 117, as it should be, it clearly appears that the notes here do not meet the statutory requirements and that the gain realized on their retirement must be included in its entirety in gross income.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

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JANUARY 1946.

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